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BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

FCC 96-93

In the Matter of	}	
Federal-State Joint Board	}	**CC Docket No. 96-45**
on Universal Service	}	

REPLY COMMENTS OF THE
AMERICAN ASSOCIATION OF RETIRED PERSONS,
CONSUMER FEDERATION OF AMERICA, AND CONSUMERS UNION

MAY 7, 1996

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SUMMARY

With the exception of one major local exchange company (NYNEX) and one major long distance carrier (MCI), the industry proposes to raise rates for core telephone service by at least $2.50 and by as much as $10.80.

The proposals to raise monthly rates for core services are unjustified as a matter of public policy. Such increases would result in a net increase in the telephone bills of residential ratepayers, and would fall most heavily on the very groups who are least able to afford telephone service.

Although the industry claims that rate rebalancing will be revenue neutral in the aggregate, the revenue neutral outcome is highly unlikely to occur for the following reasons:

(1) Competition in the long distance industry is not strong enough to force a pass-through of cost reductions quickly. In the local markets, competition is practically non-existent.
(2) Local exchange companies have extreme pricing flexibility and many LEC's profits have been deregulated. The vast majority of the LEC revenue stream remains essentially a monopoly service and, therefore, cost shifting sill result in a net increase in residential bills.

Even if rates for non-core services are lowered in an amount equal to the aggregate increases in core services, the distribution of the rate increases and decreases will be highly skewed.

(1) For the poorest two-fifths of the population, telephone bills would rise by an average of $2.73, while the richest one-fifth of the population would see their bills fall by an average of $4.60.
(2) The total increase in the telephone bill of the poorest two-fifths of the population would be $1.3 billion. The total decrease in the telephone bill of the wealthiest one-fifth of the population would be approximately $1.1 billion.
(3) The households most likely to suffer the net increase in their bills are the households headed by by persons under 25, persons over 65, and females.

Expansion of the lifeline program is not a sufficient response to a large increase in monthly charges for core services. Even lifeline program participants are likely to experience an increase in their total bills. This approach fails to provide much relief for other reasons as well:

(1) Not all states participate in the lifeline program.
(2) Many states have restrictive eligibility criteria, so only a small part of the population is covered.
(3) Only a very small percentage of the households that are eligible for assistance enroll.
(4) The working poor and lower-middle class households -- generally those with incomes between $15,000 and $30,000 -- would not be covered.

These rate increases for core services are inconsistent with the intent of the 1996 Act, unnecessary as a matter of economics, and unjustified as a matter public policy.

(1) The manner in which the industry recommends that these increases be imposed exceeds the legal authority of the Commission under the 1996 Act.
(2) None of the ratemaking provisions of the Act state or even suggest that the Commission has the authority to set or determine retail rates.
(3) Even with respect to the setting of rates for the sale of services between providers (input prices) there is considerable flexibility left to the states.
(4) The proposed rate increases are based on an erroneous allocation of joint and common costs to core services that is inconsistent with Section 254(k) of the Act.
(5) The proposed rate increases lack any evidentiary basis in this proceeding, and have been refuted by the evidence when they have been litigated at the state level.

All services that use a facility should bear a reasonable share of the costs of that shared facility. Therefore, the recovery of part of the cost of the loop from the services that use it is not a subsidy but, instead, constitutes application of the user-pays principle.

(1) The actual magnitude of the costs of those facilities should be scrutinized. Productivity gains in loop facilities have not been adequately reflected in access charges.
(2) Usage charges can be replaced by channel charges to the extent that facilities have fixed costs.
(3) All users of the loop should be required to pay for their use.

Because competition plays such a large role in the arguments about price increases, the Commission should not alter revenue streams until competition has been established. Competition is the key to protecting consumers from rate increases at the local level and the pass-through of cost reductions in long distance.

(1) The shift in revenues should not occur until after the LECs are in the long distance market.
(2) At the local level, no change in the revenue flows should take place until all of the competitive conditions in the law are in place at the local level and actual competitors have entered the local market.

The forward-looking cost model should be used by the Commission in implementing the 1996 Act. By using this model, the Commission can help consumers quickly realize the benefits of competition.

(1) During the transition, the difference between embedded historical costs and the forward-looking, most efficient cost must be analyzed in detail and steps must be taken to reduce or eliminate it.
(2) The difference between the two perspectives on cost is made up of at least four components: excessive profits, strategic investments, inefficiency, and outmoded costs.
(3) The first two types of costs should be eliminated and LECs should not be permitted to seek compensation from ratepayers. The third cause of excess costs -- inefficiency -- should also be squeezed out. The fourth source of excess costs -- outmoded costs -- requires closer scrutiny by regulators because some costs are not the fault of the companies, who were being pressured to modernize their networks by regulators.

I. INTRODUCTION

In initial comments, the American Association of Retired Persons (AARP), Consumer Federation of America (CFA), and Consumers Union (CU) pointed out that the primary thrust of the Notice of Proposed Rulemaking[1] had failed to reflect fully the intent of Congress and the President in enacting the Telecommunications Act of 1996.[2] In particular, we noted that the Notice:

1. Failed to give adequate attention to the Act's commitment to average consumers -- those who have neither low incomes nor live in high cost areas -- to ensure the availability of high quality services at just, reasonable, and affordable rates; and

2. Adopted an unjustifiably narrow view of the concept of affordability, which excluded the burden of rates on household budgets.

In so doing, the notice created the opportunity for the telephone industry to recommend rate increases in the name of universal service.[3] Unfortunately, industry commentors have proposed a very significant increase in the price of core telephone service.[4] With the exception of one major local exchange company (NYNEX)[5] and one major long distance carrier (MCI),[6] the industry proposes to raise rates for core telephone service by at least $2.50 and by as much as $10.80 per month.

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[1]Initial Comments of the American Association of Retired Persons, The Consumer Federation of American and Consumers Union, In the Matter of Federal-State Joint Board on Universal Service, Notice of Proposed Rulemaking and Order Establishing Joint Board, Federal Communications Commission, CC Docket No. 96-45, April 12, 1996.

[2]Notice, note 9, p. 4, cites the amended language.

[3]The comments of the largest local exchange companies and the largest long distance companies are summarized in Attachment 1. These companies account for over 90% of the total revenue of the telecommunications industry in this country. These entities account for virtually all of the so-called "subsidies" that are the focus of these reply comments.

[4]Historically, public policy has focused on basic service. That concept was never precisely defined. The 1996 Act will result in a formal definition of "core" services which are to be supported as the goal of universal service. This concept of core services is similar to and supplants the concept of basic service in public policy.

[5]Given the page limitations imposed by the Commission, in order to save space throughout these reply comments, we refer only to the name of the commenting party. All such references are found in In the Matter of Federal-State Joint Board on Universal Service, Notice of Proposed Rulemaking and Order Establishing Joint Board, FCC, CC Docket No. 96-45, April 12, 1996. The NYNEX (p. 2) proposal would prevent rate increases by not altering the current pattern of revenue

Because proposals of industry have so misdefined the purpose of the universal service proceeding, we have not gone into the details of designing an affordability model. Instead, we have addressed the redistribution of costs among ratepayers that will take place if the industry is allowed to raise rates under the auspices of universal service. This redistribution imposes an unjust and unreasonable burden on those least able to pay.

Our organizations believe that the imposition of rate increases for core services is inconsistent with the intent of the 1996 Act, unnecessary as a matter of economics, and unjustified as a matter of public policy for the following reasons:

- The manner in which the industry recommends that these increases be imposed exceeds the legal authority of the Commission under the 1996 Act.[7]

- The proposed rate increases are based on an erroneous allocation of joint and common costs to core services that is inconsistent with Section 254(k) of the Act.[8]

The proposed rate increases lack any evidentiary basis in this proceeding,[9] and have been refuted by the evidence when they have been litigated at the state level.[10]

flows. That is, it proposes to leave the SLC and CCL in place at current levels. Pacific Bell is silent on these matters, but Pacific Telesis (p. 14) recommends rate increases.

[6]The MCI (p. 5) proposal would reduce the payment of long distance companies for the use of the telecommunications network by $13 billion, but argues local rate increases should not be allowed to offset these reductions. MCI believes that the difference is made up of inefficiencies which would not need to be recovered in a competitive market. We suspect that such a large reduction in revenues would hardly go unnoticed by state regulators. The local companies have certainly argued that any reduction in their revenues from long distance companies must be made up.

[7]Even the two local exchange companies that did not argue for rate increases recognize that the FCC has limited authority to set local rates for core services (PacBell, pp. 19-20; NYNEX, p. 4).

[8]Bell Atlantic, p. 11-12; NYNEX, p. 3; NARUC, p. 17, Idaho Public Utility Commission, p. 17; Maine Public Utility Commission, et. al, p. 18.

[9]See the opening statement of Commissioner Sharon Nelson of the Washington to the Joint Board, April 12, 1996.

[10]NASUCA (p. 14), identifies the following states in which the costs are vastly overstated -- Maryland, Pennsylvania, Florida, New Hampshire, Maine, Washington, Indiana, Iowa, and California.

The rate increases proposed by the local companies would wipe out for years any potential price reductions that were promised to flow from the 1996 Act. Therefore, we urge the Federal Communications Commission (FCC) and the Joint Board to avoid allowing this proceeding to become an excuse for raising rates for core services. Instead, the FCC and the Joint Board should refocus their deliberations on the issue of assuring universal service. In responding to proposals by industry to increase rates for core services, we recommend a specific set of principles for preventing such increases in the transition to a more competitive industry structure.

Section II of these comments explains the arguments being put forward to justify rate increases for core services. Section III estimates the magnitude of the increases and their impact across income groups. Section IV argues that the FCC lacks the legal and evidentiary basis to impose these rate increases on the public. Section V presents the consumer view of these arguments, showing that these increases are unjustified as a matter of public policy. This section proposes a set of transitional measures that would protect the public from potentially abusive rate rebalancing while the industry makes a transition to a more competitive structure.[11]

II. THEORIES BEHIND THE PROPOSED INCREASES

In order to clarify the rationale for the proposals to increase monthly rates for core services, we will first review how the industry identifies the "subsidies" in current rates that it claims are relevant to this proceeding. Next, we focus on areas where the local exchange companies (LECs) and long distance companies (IXCs) disagree.

[11]The page limitations and time constraints imposed by the Commission also make it extremely difficult to deal with the broad range of important issues raised by the Notice and initial comments. These limitations arguably deny commentors procedural due process.

A. THE ORIGIN OF PROPOSED RATE INCREASES: AGREEMENT BETWEEN THE LECs AND IXCs

The LECs and IXCs claim that there is approximately $18 billion of "subsidies" embedded in current rates. They calculate this number by comparing current rates for core services -- basic local service -- to the current embedded cost that the LECs claim they incur for these core services.

In arriving at this estimate, most of the LECs and IXCs make a fundamental, flawed assumption about the loop. The loop is a facility used to connect ratepayers to the telecommunications network. It is used to provide all telecommunications services -- local, long distance, and enhanced services. The LECs and IXCs contend that the costs of the loop should be billed only to core services (*i.e.*, local service) and not to the other services which use the loop.[12] Both the LECs and IXCs claim that the costs of the loop are currently recovered by levying access charges on the IXCs and collecting mark-ups on the prices charged for enhanced services.

Both the LECs and IXCs argue that in some high cost (generally rural) areas, rates are below costs, while in some low cost (generally urban) areas, rates are above costs. The LECs and IXCs appear to be in general agreement that at current rates the urban-to-rural subsidy is about $5 billion. The LECs and IXCs also generally agree that this $5 billion should be made an explicit subsidy to keep the price of service in high cost areas at an affordable level. While the LECs and IXCs agree on the above issues, they break ranks on others. In particular, they disagree as to the function and appropriate disposition of the remaining $13 billion in charges for the use of the network (*i.e.*, the so-called subsidy).

[12]This is the basis of the recommendation to eliminate the CCL (See Appendix A for a list of the companies that recommend this approach).

B. WHERE THE LECs AND IXCs DISAGREE

1. THE LECs

The LECs claim that some ratepayers are the beneficiaries of the subsidy, while others are the source of the subsidy. Under the LEC view of the rate structure, ratepayers who receive core services below costs but do *not* buy a lot of enhanced or long distance services are net winners; those ratepayers who do buy a lot of these services are net losers. The LECs also claim that this pattern of subsidy flows is unsustainable in the face of competition. They contend that competitors will attack the services and areas priced above-cost, cutting off the availability of funds to support below-cost pricing of other services or areas.

The LECs demand that they be kept whole in the transition to competition. If the charges that IXCs pay for the use of the loop are reduced, the LECs want to raise rates for core services dollar-for-dollar.[13] For enhanced services, they want to raise the rates for services they feel are under-priced and lower the rates for services they feel are over-priced (*i.e.*, engage in rate rebalancing). If the LECs are unable to engage in rate rebalancing through regulation or the marketplace, they want to be made whole from a "social fund."

2. THE IXCs

The IXCs believe that a substantial part of the $13 billion of the so-called subsidies in current rates does not subsidize ratepayers. Rather, the IXCs argue that it supports the inefficiency of the LECs in the form of excess profits, overbuilt plant, and other inefficiencies.[14] The IXCs argue that in a

[13]This would be accomplished through a combination of increases in subscriber line charges and rate rebalancing (See Appendix A for the identification of the various positions of the LECs and IXCs on this issue).

[14]MCI, pp. 3,10; AT&T, p. 10 ; Sprint, p. 5.

competitive market, excess profits and the costs of inefficiencies would not be recoverable. The fact that these inefficiencies continue to exist is blamed on the failure of regulation to emulate the workings of a competitive market.

The fundamental differences between the arguments put forward by the LECs and IXCs can be stated simply. The LECs believe they should be made whole for the entirety of the $13 billion.[15] The IXCs believe that the local companies should *not* be made whole.[16] The IXCs argue that the costs should be subject to an immediate market test. They insist that the underlying monopoly elements of the network be made available to potential competitors, not at the historic costs claimed by the LECs (costs which have been inflated by monopoly protection) but at the efficient prices which would prevail in a competitive marketplace.

III. POTENTIAL RATE INCREASES AND THEIR IMPACT

A. VARIOUS APPROACHES TO RAISING RATES

1. SIMPLE ARITHMETIC

If a universal service fund of $5 billion were created, there would still be $13 billion the LECs and IXCs claim is an implicit subsidy. The LECs and IXCs assert that this implicit subsidy is paid by IXCs to LECs in the form of access charges above costs. If those access charges are reduced, the LECs believe they must be allowed to increase the charges for core services to make up the difference.

[15] GTE pp. 9,15-17; SWB, p. 6; Bell South, p. 12; US West, p. 12.

[16] AT&T argues that the LECs should receive revenues to replace any losses they suffer as a result of the reduction in CCL charge revenues.

Since virtually all industry commentors believe that the residential class is the recipient of the subsidy, they argue that this is where the rate increases should take place. Simply doing the arithmetic suggests an increase of almost $11 per month, as follows:

$13 billion ÷ 12 months = 1.083 billion/month

$1.083 billion/month ÷ 100 million residential = $10.83/line/month.

Some of the companies argue that this simple arithmetic is exactly what should happen.[17] They believe they should be allowed to rebalance rates immediately and completely as they see fit.

2. RATE INCREASES SUBJECT TO AFFORDABILITY LIMITS

Several LECs recognize that a rate increase of this magnitude might be considered a threat to universal service. They have proposed more sophisticated policies which they claim would protect ratepayers who are unable to bear the rate increases.[18] These proposals would establish a rate cap, short of full rate rebalancing, to preserve affordability. In this approach, any costs that could not be recovered in the price of core services would be added to the universal service fund and collected from telecommunications service providers. Unfortunately, the rate cap protection offered by the LECs as an affordability benchmark would provide little relief to core service ratepayers.

For example, Southwestern Bell (SWB) proposes to raise local rates to an amount equal to 1% of the median household income for a state.[19] All rates in the state would be moved to 1% of income. Any additional unrecovered costs would then be shifted to a

[17] In Appendix A this is the case for companies that advocate unlimited rate rebalancing and no affordability benchmark.

[18] In Appendix A, this can be found in the burden measure and in the method used to calculate the subsidy. Since the companies would not be allowed to draw from the universal service fund for any difference between their costs and the benchmark level, they would have every incentive to raise their rates up to the benchmark.

[19] SWB, Attachment 4.

universal service fund. This is an idea seconded by the United States Telephone Association (USTA):

> The impact of these price increases should be examined in the context of the customer's overall expenditures, interstate and state charges, for universal service to determine their impact on affordability.*/
>
> */ For example, a total expenditure of $28 for telephone service represents approximately 1% of the national median household income for the U.S. (Total expenditure of $18 represents approximately .6% of median household income levels). Given that today Americans spend, on average, approximately 2 to 2.5% of income on total telecommunications services and approximately .6% of income on basic local exchange service, an average expenditure level of 1% of income for universal services is a very reasonable expectation.[20]

As shown in Table 1 and detailed in Appendix B, this proposal provides little relief to ratepayers. Combining FCC data on rates with data on median income and population, we estimate that rates would rise by almost $9 in urban areas and by about $11 in rural areas. This proposal would result in national average rate increases of just under $9.50 per month per household. Adding in other considerations that might limit price increases, such as cost caps and/or a cost cap plus amortization of depreciation reserves, still leaves the probable rate increase in the neighborhood of $9 per month. Thus, the increase in charges for core services under the rate rebalancing proposals of the local exchange companies is likely to be somewhere between $9 to $11 per month.

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[20]USTA, pp. 16-17.

TABLE 1: RATE INCREASES UNDER INDUSTRY PROPOSALS

	AVERAGE PRICE		AVERAGE INCREASE		
	TODAY	COMPLETE REBAL	1% OF INCOME	COST OR 1% OF INCOME	INCLUDE DEPREC. RESERVE
TOTAL URBAN	18.89		8.81	8.02	8.40
TOTAL RURAL	15.89		11.21	11.33	10.80
NATIONAL AVERAGE		10.80	9.41	8.85	9.00

Source: See Appendix B.

Under most proposals, this roughly $10 increase in monthly rates for core services would take place at both the federal and state levels. There would be an increase in the Subscriber Line Charge (SLC) imposed at the federal level of between $2.50 and $3.50. The remaining increase would be addressed by rate rebalancing at the state level.

B. REVENUE NEUTRALITY IN THEORY AND PRACTICE

1. REVENUE NEUTRALITY IS NOT A LIKELY OUTCOME BECAUSE OF MARKET IMPERFECTIONS

The first line of defense that the LECs and IXCs offer for the increases in monthly rates for core services is revenue neutrality. The IXCs claim that although they would experience lower costs, they would pass them through to consumers in the form of lower long distance bills. However, these savings could be offset by increases in the monthly bill for core services paid by consumers. In fact, state commissions could order LECs to increase rates for some services and decrease rates for others.

In our view, the "revenue neutral" outcome is highly unlikely to occur even in the aggregate. Moreover, even if some rates are lowered to offset rate increases, the majority of individual residential ratepayers are not likely to see a neutral outcome in their bills. To the contrary, they are likely to experience net increases in their bills.

On the long distance side, competition is not strong enough to force a pass-through of cost reductions quickly. IXCs will try to hold on to as much of the $13 billion as they can for as long as they can. Price leadership by AT&T and "umbrella pricing" by its much smaller competitors are more likely to characterize how the market functions -- $13 billion is a very large umbrella for them to live under.

To the extent that competition does force the pass-through of cost reductions, it is likely to benefit the more or most competitive market segments first. High volume and business users will benefit the most.[21] Residential ratepayers will see price reductions last and least.

On the local side, the extreme pricing flexibility most LECs now enjoy and seek to have expanded would mean that revenue neutrality would not endure. Profits have been deregulated for many companies. The companies have an incentive to shift costs onto the most regulated prices of customers who have the fewest choices. These increases would be offset by cost reductions for the least regulated services. The companies can be expected to increase rapidly their profits by raising prices as quickly as possible wherever possible, while targeting price reductions to their most competitive lines of business. The average residential ratepayer will benefit least.

The likelihood that competition in local markets will prevent this outcome in the short term is small. First, local companies do not face effective competition for core telephone service in the residential market. Indeed, competition in this market is virtually non-existent. The vast majority of the LEC revenue stream remains essentially a monopoly service and, therefore, cost shifting will result in a net increase in residential bills. The conditions necessary to promote competition are complex.

[21] At least one of the large business groups filing comments supports rate rebalancing (see Ad Hoc Telecommunications Users Committee).

Although the new law has the purpose of stimulating competition, it remains to be seen how quickly new competitors can actually enter local markets. Until they do, rate rebalancing is likely to result in net increases for residential ratepayers.

2. LOWER AND MIDDLE INCOME RESIDENTIAL RATEPAYERS ARE HARMED BY REVENUE NEUTRAL RATE REBALANCING

Even if rates for non-core services (like Call Waiting or long distance) are lowered in an amount equal to the aggregate increase in core services, the distribution of the rate increases and decreases will be highly skewed. The net effect is a huge transfer of wealth from the poorest two-fifths of the population (with incomes below approximately $30,000) to the wealthiest one-fifth (with incomes above approximately $67,000). This shift occurs because the wealthiest one-fifth consumes twice as much of the non-core services as the poorest two-fifths.

As Table 2 shows, all groups paid an average of approximately $18.80 for telephone service in 1993 (the most recent year for which data are available). The national average expenditure for non-core services was $39.40. The distribution of these expenditures was, however, highly skewed.

TABLE 2: WEALTH TRANSFER FROM RATE REBALANCING

	NATIONAL AVERAGE	POOREST	QUINTILES 2ND	QUINTILES 3RD	QUINTILES 4TH	RICHEST
1993 BILLS						
TOTAL BILL	58.20	46.80	48.00	55.80	61.50	76.30
NON-CORE	39.40	28.00	29.20	37.00	42.70	57.50
CORE	18.80	18.80	18.80	18.80	18.80	18.80
REVENUE NEUTRAL REBALANCED BILLS						
TOTAL BILL	58.20	49.69	50.58	56.40	60.65	71.70
NON-CORE	29.46	20.89	21.78	27.60	31.85	42.90
CORE	28.80	28.80	28.80	28.80	28.80	28.80
NET CHANGE IN TOTAL BILL FOR SAME SERVICE	0	2.89	2.58	.60	-.85	-4.60
AGGREGATE CHANGE IN COSTS ($MILLION) @ 100 MILLION HH)	0	694	619	144	-204	-1104

SOURCE: McMaster, Susan E. and James Lande, Reference Book: Rates, Price Indexes, and Household Expenditures for Telephone Service (Industry Analysis Division, Common Carrier Bureau, Federal Communications Commission, November 1995), Table 4

The poorest one-fifth of the population spent $28 for non-core services. The next poorest one-fifth spent about $29.20 for non-core services. For the income groups above this level, the spending on non-core services increased steadily to over $57 among the top one-fifth of the income distribution. This is twice the level of expenditures on non-core services as observed among the bottom 40% of the income distribution. Therefore, the wealthiest group benefits twice as much as the poorest group from revenue neutral rate rebalancing.

The bottom half of Table 2 makes the following assumptions to illustrate this point. It assumes a revenue neutral, across-the-board shift in prices. That is, it assumes that core service rates are increased by $10 per month (about the mid-point of the range of estimates in Table 1), while non-core service rates are reduced by a uniform percentage sufficient to produce revenue neutrality. On a national average basis, expenditures for core services would rise to $28.80, while the price of non-core services would decline to $29.40, a 25.4% reduction. This is the best possible scenario, based on an assumed 100% pass-through of cost savings. In fact, total bills may very well rise.

The total bill for the poorest one-fifth of the population would rise from $46.80 to $49.89 per month. Because they consume far fewer of the non-core services, their cost savings do not offset the cost increases for core services. For the next poorest one-fifth, the total bill would rise to $50.58 from $48 per month. The total bill for the third quintile would rise by $.60. For the fourth quintile, it would fall by $.85. For the wealthiest one-fifth of the population, the total bill would fall by $4.60 per month. Approximately two-thirds of the population ends up worse off.

Assuming approximately 20 million households in each quintile, the total increase in the telephone bill of the poorest two-fifths of the population would be $1.3 billion. The total decrease in the telephone bill of the wealthiest one-fifth of the population would be approximately $1.1 billion.

It is also important to note that the households at the bottom of the income distribution are particularly vulnerable. These are households headed by the young, older persons, and females. While the bottom two quintiles represent 40% of the total population, 64% of households headed by persons under the age of 25 fall in this category; 66% of households headed by persons 65 or older are in this group, as are 62% of female headed households.[22]

This impact on the bottom two quintiles must be considered from the point of view of both the penetration rate and the burden aspects of the concept of affordability. Although the bottom two quintiles represent 40% of the population, approximately 75% of all households without telephone

[22]U.S. Department of Commerce, Statistical Abstract of the United States, September, 1995, Table 728.

service are found among these lower income households.[23] Paying more for phone service represents a reduction in the available financial resources which are needed for basic necessities.

3. EXPANDING LIFELINE PROGRAMS

The LECs recognize that even if revenue neutrality could be achieved, it would not allay all concerns about rate impacts. Increases in monthly charges for core services to fund reductions in charges for other services will fall most heavily on those who buy less of the other services. Core services are a necessity and rate increases in this area cannot be avoided by the residential ratepayer.

The LECs generally support expanding lifeline programs to include more people and to cover at least part of the rate increase.[24] Under the current structure of lifeline programs, the FCC reduces the federal SLC in an amount equal to the discount a state offers to low income households on basic monthly services. For a state fully participating in the lifeline program, the total discount would be \$7.00 (a complete waiver of the current \$3.50 SLC matched by a \$3.50 reduction in basic rates).

If the SLC were increased by \$2.50 (roughly the amount needed to eliminate the Common Carrier Line (CCL) charge) and the FCC simply added this amount to the current policy, lifeline rates would be discounted by an additional \$5. If rate rebalancing were held to this level, lifeline program participants would be held harmless. Given the proposals to establish the core services affordability benchmark in the range of \$28.80, however, rate rebalancing is likely to go far beyond this level if the LECs convince the FCC to preempt the states. Even lifeline program participants are likely to experience an increase in their total bills.

[23]Bureau of the Census, Current Population Survey, November 1994.

[24]See Appendix A. It is particularly ironic that SWB suggests expanding the lifeline program to all households below poverty when Texas (its largest state) has very restrictive criteria for enrollment in the program.

This approach fails to provide much relief for other reasons as well:

- Not all states participate in the lifeline program.
- Many states have restrictive eligibility criteria, so only a small part of the population is covered.
- Only a very small percentage of the households that are eligible for assistance enroll.
- The working poor and lower-middle class households -- generally those with incomes between $15,000 and $30,000 -- would not be covered.

IV. THE LACK OF A LEGAL AND EVIDENTIARY BASIS FOR CORE SERVICE RATE INCREASES

A. THE LEGAL BASIS FOR THE CLAIM FOR FEDERALLY MANDATED RATE REBALANCING IS ABSENT

1. STATE RATEMAKING AUTHORITY

The pre-emption of state ratemaking authority requested by several of the LECs and IXCs exceeds the authority granted to the FCC under the 1996 Act. The Act preserves to the states the authority to tailor the general policy for implementing universal service and local competition to the unique circumstances of each state. At each turn -- and specifically in sections 251(d)(3), 252(d), 253(b), 254(f) -- the 1996 Act preserves the authority of the states to implement the policy.

Not once in any of the ratemaking provisions of the Act does it state or even suggest that the Commission has the authority to set or determine retail rates. Earlier versions of the bill had different pre-emption language with respect to retail ratemaking which was taken out of the conference report. To suggest that the FCC should order states to rebalance $13 billion in rates under any of these sections is a gross misinterpretation of the power that Congress intended for the Commission to exercise.[25]

Even with respect to the setting of rates for the sale of services between providers (input prices) there is considerable flexibility left to the states. The states can generally adopt approaches to pricing that are not inconsistent with the policy adopted by Congress. They are not required to price precisely as the FCC orders. Indeed, the FCC lacks the authority to order specific approaches to pricing.[26]

2. RECOVERY OF JOINT AND COMMON COSTS

To the extent that the vast majority of rate rebalancing proposals is driven by the intention of the industry to recover loop costs in a basic monthly charge paid by end-users, the entire thrust of rebalancing is inconsistent with the joint and common cost language of Section 254 (k). This Section requires that core services recover, at most, a reasonable share of joint and common costs. Allocation of 100% of loop costs to core services is not reasonable and is inconsistent with the law.[27]

[25]Even Pacific Telesis points out the limitations on the authority of the FCC to interfere with intrastate rate making (pp. 19-20).

[26]NYNEX points out that competitive businesses apply a wide variety of approaches to recovering joint and common costs in the costs of the goods and services they sell (pp. 4-5). Therefore, there are no grounds for the Commission to claim that only one treatment of joint and common costs is consistent with the competitive intentions of the Act.

[27]Not only the consumer advocates echo this view of the loop (NASUCA, p. 17, OPUC, Texas, p. 6). Bell Atlantic (p. 11-12) and NYNEX (p. 3) both point out that CCL charges represent the recovery of joint and common costs. State regulators also take this view (Maine, Vermont, etc., p. 18; Idaho, p. 17). It is also ironic to note that Sprint claims that the Benchmark Cost Model treats loop as a common cost for enhanced services, yet, fails to accept the fact that loop is a common cost for long distance services. Similarly, Pacific Bell (p. 18) invokes Smith v. Illinois as a principle of cost sharing between the federal and state jurisdictions, yet the state regulators believe this principle requires long distance to share in common costs (Maine, Vermont, etc., p. 18).

B. EVIDENCE

The industry's claim that core services are subsidized has not been demonstrated. The FCC has never conducted a proceeding to document this assertion. In fact, the vast majority of states that have looked at this question in detail have found exactly the opposite. NASUCA lists the following states in which company cost studies have been found to result in 'inflated costs for basic exchange service:"[28] Maryland, Pennsylvania, Florida, New Hampshire, Maine, Washington, Indiana, Iowa, and California. These states represent almost one-third of all telephone subscribers in the nation. None of the companies have put any cost data into this proceeding. Several industry commentors refer to ARMIS book costs (*e.g.*, US West, SWB), but these costs have never been subject to regulatory scrutiny and they have not been found to be prudent by any regulatory commission. To the contrary, state commissions have generally found these costs to be vastly over-stated. For example, Commissioner Sharon Nelson noted in her opening statement to the Joint Board that the Washington Utilities and Transportation Commission had just found that US West's costs in Washington were $10.50 per month.[29] The ARMIS data for Washington shows an average cost of $33.40 (U S West, Schedule 3), over three times as high.

V. THE CONSUMER VIEW

A. THE RECOVERY OF COMMON COSTS

In our initial comments, we asserted that all services that use a facility should bear a reasonable share of the costs of that shared facility. Therefore, the recovery of part of the cost of the loop from

[28]NASUCA, p. 14.

[29]"Fifteenth Supplemental Order: Decision and Order Rejecting Tariff Revisions; Requiring Relief," Docket No. UT-9502000, Washington Utilities and Transportation Commission v. US West Communications, Inc.).

the services that use it is not a subsidy. Rather, it constitutes application of a user-pays principle that is required by the 1996 Act. Virtually all other consumer advocate commentors share this view in their initial comments.[30] Two of the LECs take this point of view,[31] as do a number of state regulators.[32]

The user-pays principle should not be abandoned. Service providers should not use facilities without paying for them. If they are permitted to do so, average residential ratepayers will bear the burden of the large fixed monthly costs of network capacity, while service providers and intensive users avoid their fair share of the costs.

As long as the user-pays principle is preserved, more efficient mechanisms for recovering shared costs can be implemented. As a result, we propose the following:

- The actual magnitude of the costs of those facilities should be scrutinized. Productivity gains in loop facilities have not been adequately reflected in access charges.

- Usage charges can be replaced by channel charges to the extent that facilities have fixed costs.

- All users of the loop should be required to pay for their use.

Consumer advocates agree that the rural-to-urban subsidy exists and should be maintained.[33]

B. CONSUMER PROTECTION IN THE TRANSITION TO COMPETITION

Competition plays a key role in both the LEC and IXC arguments. The IXCs claim that, in the face of competition, neither they, nor the local companies, will be able to impose rate increases on anyone. They claim that any cost reductions received will have to be passed-through to consumers

[30] OPUC, Texas; NASUCA; OCC, Ohio.

[31] NYNEX, p. 3; Bell Atlantic, pp. 11-12.

[32] NARUC, p. 17; Idaho, p. 17.

[33] OPUC, Texas, p. 2;

because of competition in the long distance market. Further, they say that if regulators adopt sound policies promoting local competition, local rate increases will be avoided. LECs invoke competition in several ways as well. First, they claim that they must rebalance rates because of competition. They assert they can no longer price rural areas and residential service below their costs because competition will attack their urban business customers who are priced above cost. Second, they argue that competition will regulate their ability to increase prices. Because competition plays such a large role in the arguments about price increases, we believe that the Commission should not alter revenue streams until competition has been established. Competition in long distance will be the key to forcing the pass-through of cost reductions. Competition is also the key to consumer protection at the local level. As a result, we propose the following:

- For consumers to receive the best deals on long distance, the shift in revenues should not occur until after the LECs are in the long distance market. Meeting this condition will increase the likelihood of a pass-through of any cost reductions because it will assure a full complement of competitors, which will result in downward price pressure

- At the local level, no change in the revenue flows should take place until all of the competitive conditions in the law are in place at the local level and actual competitors have entered the local market. We believe that a strong competitive environment is essential to protect consumers from rate increases.

C. THE PROBLEM OF INFLATED COSTS

The forward-looking cost that the IXCs rely on in their comments is the most efficient, long-run cost that can be found based on engineering cost models. Because it would take years, or even decades, to build a network at the most efficient costs, this cost model should be used by the Commission in implementing the 1996 Act. By doing so, the Commission can help consumers quickly realize the benefits of competition. If other, less efficient cost models are used, higher rates will remain in place for a long period of time. In essence, we believe that if competition that restrains pricing is to occur sooner rather than later, regulators must adopt the IXC view of cost and price the use of bottleneck network facilities at the long-run price in order to make entry easy.

While the sale of monopoly network functions to competitors should be at the forward-looking, most efficient cost, retail prices should be allowed to transition to this level over time. This sends the correct price signals to telecommunications service providers in the near term, while providing an opportunity for incumbents to adjust their costs.

During the transition, the difference between embedded historical costs and the forward-looking, most efficient cost must be analyzed in detail and steps must be taken to reduce or eliminate this difference. In our view, the difference between the two perspectives on cost is made up of at least four components.

1. Excessive profits. Unjustifiably high profits have resulted from the inability of regulators to reduce rates of return, the institution of price cap regulation (which vastly under-estimates productivity gains), and a lack of competition for core services.

2. Strategic investments. Under regulation, the local companies have deployed capital assets in anticipation of movement into other businesses (*e.g.* video delivery and long distance service), the costs of which have been recovered in local service rates.

3. Inefficiency. Unnecessarily high costs have resulted from decades of local franchise monopoly and have been perpetuated by indexing under price regulation.

4. Outmoded costs. Embedded costs associated with the pattern of investments that occur in a capital intensive industry with long-lived assets, uneven competition, and changing regulation could exceed theoretical forward-looking, long-run costs. The combination of an obligation to make certain investments, dramatically declining costs of providing service in an industry typified by lumpy investment, and regulatory changes may have left some assets, which were prudently economic at one moment, no longer economically viable.

We believe that the first two types of costs should be eliminated and that LECs should not be permitted to seek compensation from ratepayers for the following reasons:

- A persistent pattern of excess profits has existed for a decade.
- Similarly, consumer advocates have expressed continuing concern about the misallocation of over-investment in the network to local rates and believe that these should be removed.[34]

The third cause of excess costs -- inefficiency -- should also be squeezed out. Although regulators have allowed the costs to be collected in rates and while it may be necessary to provide a transition period to allow companies to lower their costs, the ultimate goal should be efficient operations. Regulation was never intended to countenance inefficiency; the purpose of introducing competition is to eliminate inefficiency.

The fourth source of excess costs -- outmoded costs -- requires closer scrutiny by regulators. For example, the fact that switching costs have fallen from $400 per line five years ago to $45 per line today is not the fault of the companies, who were being pressured to modernize their networks by regulators.[35] Real world competitive markets rarely react so quickly or smoothly in fully adjusting to dramatic economic changes in the short-term. Regulatory changes may also impose costs on firms that would not occur in a competitive marketplace. The ultimate goal is to squeeze these costs out, too.

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[34]Richard Gable, The Impact of Premium Telephone Services on the Technical Design, Operation and Cost of Local Exchange Plant (Public Policy Institute, AARP, 1992).

[35]This situation must be carefully distinguished from the situation in which a company continues to deploy switches at very high prices today instead of reconfiguring the network in a more efficient manner.